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SIPDIS

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TAGS: ECON EFIN ELAB PGOV CO
SUBJECT: COLOMBIAN BANKING REGULATIONS STABILIZE SECTOR

¶1. (U) SUMMARY. Colombia's banking regulators aided struggling banks through the banking crisis of the late nineties and have continued this work by strengthening banks against risk. Colombia has implemented internal regulation to ensure against another banking crisis while also implementing Basel I standards (and beginning to implement Basel II) and by moving toward a standardized system to predict possible losses (SARC). These regulations have advanced and strengthened the Colombian banking sector enough that Colombian industry experts are confident that past crises will not be repeated. END SUMMARY.

¶2. (U) Colombia's financial sector is at last emerging from the 1998 crisis. Colombian bank regulators attributed the bank failures of the late 1990s to improperly controlled credit risk. The Senior Economist from Superbancaria, Carolina Baron, expounded upon this by saying that the banking crisis was triggered by skyrocketing interest rates (due to the Asian and Russian crises) for emerging markets. Individuals and companies simply could not pay the interest on their loans, which led to high rates of default. This was clearly evident in the mortgage sector as individuals struggled to pay interest on mortgages. Baron said this created a crisis of confidence in the banking sector. Industry experts reported that in Q2 1999, a deep fiscal gap (the fiscal deficit was 5.2 percent of GDP in 1999 compared with 2.8 percent for 2003) sparked a currency crisis (the peso devalued 20 percent). This further weakened investor confidence. Non-performing loans rose from 8 percent of total loans in 1998 to 14 percent in 1999. The GOC took action to protect depositors and through direct intervention rescued many of these banks, but the bailout cost a total of 4.3 percent of Colombia's GDP over a period of three years, from 1998 to 2000.

HISTORY - FOGAFIN

¶3. (U) Founded in 1985 after a banking crisis, the Fondo de Garantas de Instituciones Financieras's (FOGAFIN) goal is to increase confidence in the Colombian financial system by insuring individual deposits and by working with banks through failures and restructuring, along the lines of the U.S. Federal Deposit Insurance Company. FOGAFIN insured deposits beginning in the mid eighties and continued its work by restructuring banks throughout the financial crisis of the late nineties; however, it has not effectively achieved its goal of increasing investor confidence. Part of the blame lies in the fact that FOGAFIN does not have the name recognition among the Colombian population to effectively build confidence in banking deposits. Additionally, FOGAFIN insures less than USD 8,000 per individual account and takes 3 to 4 months to pay in the event of a failure.

¶4. (U) FOGAFIN's work to restructure banks has been more successful. By purchasing a private sector asset management company specializing in mortgage loan collection, Central de Inversiones (CISA), FOGAFIN worked to stabilize the Colombian banking system against future crises. CISA recapitalized private and state owned financial institutions and dismantled bankrupt institutions. FOGAFIN and CISA have taken on non-performing assets from multiple banks in order to help stabilize the industry. Industry experts told Econoff that CISA did not use public funds to save private investors. Instead, FOGAFIN issued bonds to capitalize CISA, and then used those funds to purchase non-performing loans and real-estate properties. CISA worked to collect or write-off non-performing loans. In addition, once regulators increased the capital requirements for these banks, FOGAFIN offered loans to banks. This joint effort by FOGAFIN and CISA stabilized banks and saved Colombia from even greater crisis.

SUPERBANCARIA

¶5. (U) The banking superintendency, Superbancaria, is the regulatory arm of the banking industry. It works closely with FOGAFIN to offer greater access to credit for struggling banks, but its main mission since 1923 has been to guarantee the solvency and stability of the financial system in Colombia. The superintendency is currently working with banks to implement risk classification on a test basis and to assist with loan provisioning). Superbancaria plays an important role in monitoring weak mortgage institutions and recently began monitoring market and institutional risk. In

December 2003, the Colombian Congress received a draft budget from the Uribe administration requesting full budgetary autonomy for Superbancaria, which should allow for more effective monitoring across the financial sector. Law 795 of January 2003 increased independence of the financial institution's decision making; strengthened the code of conduct for administrators at institutions; and gave the banking superintendency greater regulatory and supervisory powers.

POST CRISIS REGULATION

¶6. (U) Regulators believe the implementation of Basel I regulations, the implementation of a System of Credit Risk Administration (SARC) and the beginning steps to put the banking sector in line with the Basel II accord and international accounting standards will reduce credit and market risk and increase confidence.

¶7. (U) GOC regulators see all regulations as moving toward SARC and cited two specific examples that they felt would help implement SARC and would greatly strengthen the Colombian banking sector. The SARC is a statistical model to determine future losses from credit portfolios which can help to evaluate risk. Currently, banks hold a lot of government securities, increasing market risk. With a capital cushion that is continually evaluated by bank regulators, banks and the government are able to reduce this exposure to market risk. The first step to move toward SARC was in 2000 when the GOC instituted regulations establishing early warning signals to indicate when a bank is nearing financial trouble, when liquidity is compromised and when capital goes below a certain level. Regulators see these warnings signs as an important step to reduce market risk and give the government time to react early when stability is compromised.

¶8. (U) 2002 regulations created a system in which banks must evaluate the market value of their assets and electronically send that information to Superbancaria. This system is similar to the CAMEL ratings system, which was developed by the US Federal Reserve (FED) to monitor and evaluate risk. Much like with CAMEL ratings, Colombian banking regulators classify risk as credit, market, liquidity, operational and money laundering risk. While the FED evaluates banks by on-site examinations, Superbancaria receives this information electronically. While the lack of off-site evaluations increases the risk that banks might send false information, industry experts note that banks would face sanctions and a possible revocation of their charter for false information. In 2003 as part of SARC, banks were required to complete the third phase of internal loan loss classification and reserve methodologies based on expected loss.

¶9. (U) Regulators emphasized that these steps toward a more closely monitored banking system will aid against market and credit risk; however, there were laws passed after the banking crisis that regulators saw as harmful or incomplete. First, a 2001 ruling by the constitutional court requires mortgage loans to be no more than fifty percent of the price of the house. This law has negatively impacted poorer families because it is now more difficult to get a housing loan; individuals must pay up front fifty percent of the cost of their mortgage. Second, the GOC passed regulation in 2000 for derivatives, which outlined how to calculate market value. Regulators mentioned that they believe the GOC should push for greater reforms in the area.

¶10. (U) COMMENT. Colombians are gaining confidence in their banking system since the crisis of the late nineties. Experts are generally confident in their banking system and those in the banking sector believe the new regulations have raised the system to international standards. While regulations have improved and the banking sector has grown, many analysts are still concerned about the market risk inherent in holding a large amount of government denominated debt. END COMMENT.
DRUCKER